DOW THEORY LETTERS INC.

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THE MARKET: Visitors to San Diego often attend their first bull fight, a procedure which requires a trip 20 miles south to Tiajuana, just over the Mexican border. The bulls have never seen a man on foot before, nor have they ever seen a cape. Therefore, it is not unusual to witness the bull mistake the cape for its tormentor. I have often seen a maddened bull rip the cape from the matador, dash it to the ground, and stomp it to shreds. It's simply a matter of inexperience on the part of the bull; he's wasting his energy fighting the wrong battle.

By the same token, when interest rates rise to uncomfortable levels our bull-headed politicians and economists rush in to fight the wrong battle. If interest rates on Certificates of Deposit and on bank deposits and Savings & Loan deposits are "too high," why it's simple, just pass a law to lower them. Disregarding the fact that the 91-day Treasury bills are now yielding 5.4% and 181-day bills are yielding 6% in the free market, our lawmakers have put a ceiling on savings and bank interest rates. This means that the Government is now in a position to ciphon off billions of dollars from bank deposits and Certificates of Deposit. Only the ignorant are going to keep their money in the bank when they can get 6% on 181-day Treasury bills.

Furthermore, President Johnson has announced that the Treasury (probably impressed by the great success of bank Certificates of Deposit) is coming out with its own C/D at a "much higher rate of interest" than the 4.15 paid on savings bonds. This makes the picture complete. As predicted a year ago, the U.S. Government is now taking on all comers for cash. And it is going to get that cash, no matter what! The nation is now engaged in a war that is growing so rapidly that even such Administration-oriented publications as Business Week and Forbes have, within the last two weeks, come out with editorials warning that enough is enough.

Bear markets are made to separate men from their hard-earned money. For instance, a bear market rally occurs, and the bulls are encouraged. Then the rally fizzles, boosting the hopes of the bears. Suddenly the rally assumes new strength, and the bulls can feel the blood pounding in their veins. A series of ascending zig-zags develops, suggesting that "something big on the upside" is in the wind. Finally, with the short sellers being squeezed and running for cover, and with many new buyers entering the market, the whole structure staggers and crumbles. The shorts have taken their losses, and the new buyers are

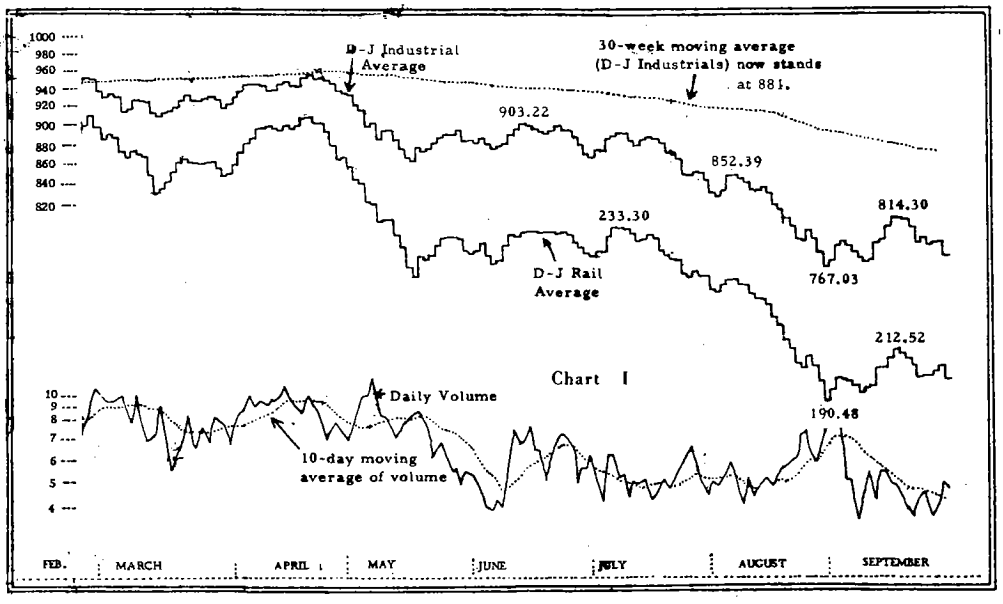
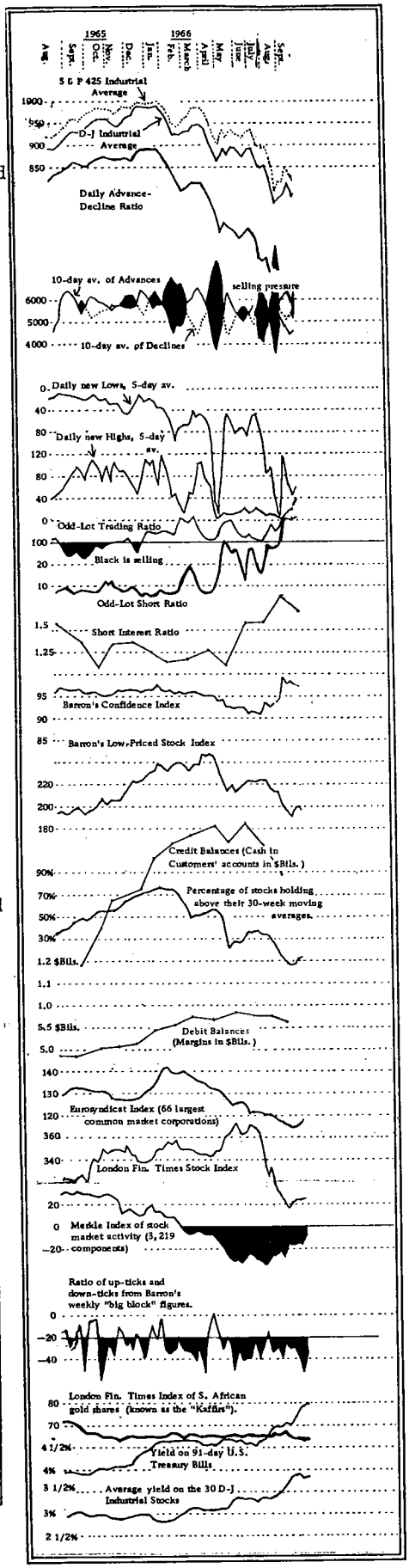


Chart I


1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Meddle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills.
Average yield on the 30 D-J Industrial Stocks

suffering mounting losses of their own. The preceding secondary lows are violated by both Averages, and a new bear leg is underway. It has been a frustrating experience; it looked "different" from the last rally (and in some ways it was), but the net result is the same. Many investors and traders have suffered severe new losses, losses they never would have sustained had they resisted the siren song of the bear market rally.

Sooner or later the type of bear market action described above is going to discourage the public. Sooner or later the public is going to realize that the only safe place in a bear market is on the sidelines. Hints that this is now occurring can be seen in the profile of volume on the N.Y.S.E. Gradually, month after month, the general trend of volume is subsiding, and this suggests that the Wall Street game is beginning to lose its players. The public is fickle and impatient, and if it cannot have its own way fast, it will lick its wounds and leave. Even Mutual Fund sales have been subject to this trend, and the latest figures (August) show net funds sales down for the fifth month in a row, down a whopping 51% below the earlier March figures.

NOTES & QUOTES: Great confusion is being generated by the spectacle of a bear market in stocks accompanied (so far) by many inflationary forces in the economy. The steady rise in consumer prices seems to reinforce the public's bullish attitude towards inflation, and it seems that it will take more than a collapse on Wall Street to turn the public bearish (see section of odd-lots). Generally, it requires about a year of adversity before the public will undergo a complete change in its attitude and psychology. Given the fact that the bull market topped out in February, 1966, I would guess that the public is not going to turn bearish until late Fall or sometime in the Spring of 1967. When that occurs, there is liable to be a mass rush for the Wall Street exits. This is the real reason why, despite a 228 drop in the Dow, the market has not developed panic conditions. The public is still just too bullish. But we can be sure that as the bear market continues, this bullish attitude is going to change.

Many European markets are now down 25% to almost 50% from their old bull market peaks. Europeans have been deflating their economies in order to protect their currencies and reserves. It is only a matter of time before the booming American economy will be subject to the same forces. When this happens, the final lid will be clamped on the equity markets of the world. Along these lines, it was most interesting to read this interview with a leading Austrian banker documented by economist Melchior Palyi (September 20): "You Americans have arrived at the same monetary philosophy that was the earmark of the French Revolution after 1791. The Jacobins believed that France was endowed by all the good things of life, except one -- money. That deficiency could be easily remedied by printing what is known today as purchasing power - until it had ceased to purchase anything. America is inflicted by the same illusion. Your authorities pay lip-service to stable prices and balanced foreign payments, but do little more than nothing to bring them about.

"The prevailing lack of sincerity has been graphically illustrated by a recent statement of your President. Mr. Johnson announced that the inflation's impact had been reduced by taking 10 billion dollars out of circulation. In reality, nothing of the sort had been done. The public has 10 billion dollars less to play with. the government spends 10 billions more.

"I have in front of me the latest reports of a leading New York bank. The reports of this bank, which are widely read in Europe, used to be in the forefront of the fight for sound money and free enterprise against inflation and subsidies. Now, when the bank's own profits are pinched by the money squeeze, its philosophy has made a 180-degree turn. Its latest reports pooh-pooh the inflation and urge the government to give more subsidies to homebuilders."

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Writing from Paris, economist Eliot Janeway notes in his September 21 Janeway Service: " On the question of what happens when the accelerating run on American gold reserves brings us to the statutory limit, French opinion is divided. The dogmatists' view is that we will play the conventional hand, and embargo gold. But the pragmatists expect us to make the sensible move, called for by our own national interest, and revoke the 'put' which now requires us to buy gold. Of course, if the U.S. were to demonetize gold, France and Germany would be caught short of dollars. This prospect is all the more frightening in Paris because of the universal judgment that Britain is through - "dying" is the word in vogue - and that, therefore, devaluation in Britain and all through Europe is only a matter of time (with 1967 a likely target).

"Thus, the pragmatists, who expect the U.S. to play the obviously strong hand it holds, are fearful that the gold play against the dollar will cost Europe dear; and certainly a general European devaluation would leave the dollar worth more, not less. What French pragmatists find difficult to understand or accept, however, is our purposeless drift. Their own setup is so tightly controlled; their Treasury directs their banking system so firmly; their industry is so closely involved with (and, indeed, to such a large extent owned by) the Government; their impression of LBJ from afar so thoroughly takes for granted a continuation of his 1964 initiatives - that the French find it difficult to believe that we will do nothing in protective anticipation of a dollar-gold crisis.....

"It will take the next downward leg of the stock market, plus the outbreak of credit troubles, to awaken sophisticated French opinion to the realization that Johnson is no longer in control in Washington, and that Washington is no longer in control of the financial situation. The full bearish impact of this discovery is yet to be felt. The reaction in Paris to LBJ's public relations play promising an easing of the money strain was as naive as that in Wall Street."

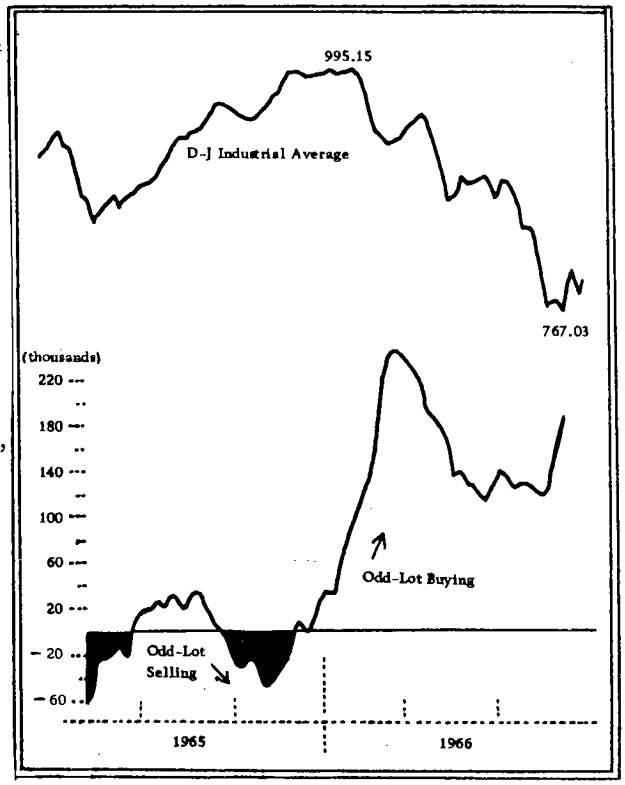
I study the business news, I watch the price structure, and I ask myself the following question: How long will it be before the American public loses confidence completely? How much longer before the current state of confusion turns to consternation, disillusionment and finally panic? Anybody who really understands just a part of what is going on in Washington and in our economy is at the stage where he is tearing his hair out. When the public begins to "figure out" the situation, I feel they will become frightened, turn from their current odd-lot buying to heavy selling, and the next crushing downward leg of the bear market will be on. I would expect the next major descent to be more violent and more costly than anything seen so far. Why shouldn't it be? In all likelihood the great American public will be throwing its weight behind the next decline. We have not, so far in this bear market, seen a panic with the public participating fully in the selling (up to this point the public has remained optimistic and been a buyer on all declines).

CONCLUSION: The primary trend of the market is bearish, and this is the fact that should guide all true investors. The secondary trend could be in the process of turning bullish, but I would want the Averages to better their September highs of 814.30 and 212.52 before I even turned bullish on the secondary trend. The minor trend (with the Averages zig-zagging down) is now bearish.

THE BIG TRANSFER (Chart page 3): I have wanted to present the odd-lot picture in as graphic a manner as possible. Therefore, I have taken the official S.E.C. weekly figures (from Barron's) and arranged them as follows. Weekly sales of shares were subtracted from weekly purchases (the reverse where sales were greater than purchases) and these figures were computed on the basis of a 10-week moving average. Thus, the long-term trend of public buying or selling is "smoothed out" on a moving average, and I have superimposed the D-J Industrial Average above the odd-lot figures. The resultant picture is informative.

As a rule, important accumulation takes place while the public is selling; conversely, important buying occurs while the public is buying. The chart covers the period from April, 1965 to the present. It is clear that during much of 1965 the public was rather

sceptical or just mildly interested in the advancing stock market. For a brief period during July and August the odd-lotters purchased more than they sold, but towards the end of 1965 they reverted back to their selling again.



Then something happened. As the Dow approached the 1000 level the public stepped up its buying considerably. Evidently the public believed that "it was only a matter of time" before all stock purchased under 1000 (on the Dow) would appear cheap and in a "bargain area." It was not fated to be. Having missed 1000 by a mere 5 points, the Dow turned down. Then, in the face of the sagging stock market, the odd-lotters swarmed in, buying at the highest rate seen since the entire rise began in 1962.

The severe market slide of 1966 evidently failed to scare the odd-lotters, although they reduced their buying somewhat as the decline gathered momentum. The lowest ebb of buying (based on the 10-week moving average) occurred during the week of July 24. Since then, as seen on the chart, odd-lot purchases have increased again. Whether the very high March-April rate of buying will be seen again in this bear market is doubtful, but it is obvious that the public is still bullish and hopeful. Declines are still seen as "buying opportunities" and rallies are still seen as resumptions of the "upward trend." The persistent public enthusiasm, as measured by the 10-week moving average of odd-lot transactions, is not a hopeful phenomenon at this time. Remember, before bear markets end the public usually turns stonily pessimistic, and at such times they are hardly apt to be buying heavily on balance. At the final bear market bottom, I would expect the odd-lot transactions to be just the opposite of those pictured on the chart.

QUESTION: Why aren't you more impressed with the new record high short interest, the high level of debit balances (margins), the relatively lower volume and some of the other bullish indications now showing in the stock market? ANSWER: Every bear market is different. What works in one bear market may not work in the next. Too many people were watching the same indicators during the first quarter of 1966, and the market evidently discounted those indicators. When everyone is watching the same indicator on Wall Street, forget it, that indicator is about to go sour. Or as an old market veteran once told me, "the art of market analysis is sensing what signs and signals to throw out at any given time." For instance, I wrote a good deal about the Utility Average in my Letters of February, March and April. Now everybody is scrutinizing the Utilities for bullish signs. Therefore, I have stopped talking about them. The important thing to remember is this--a major primary bear market is underway. That fact overrides all others. This bear market should end under vastly different circumstances than are now apparent. Some of the things we will see at the final bottom are great public pessimism, extremely low volume, sideways "drag" of the Averages, a collapse in debit balances, a cave-in in speculative and low-priced shares, a sufficient time lag (a year or more) to correct a 17-year old bull market.

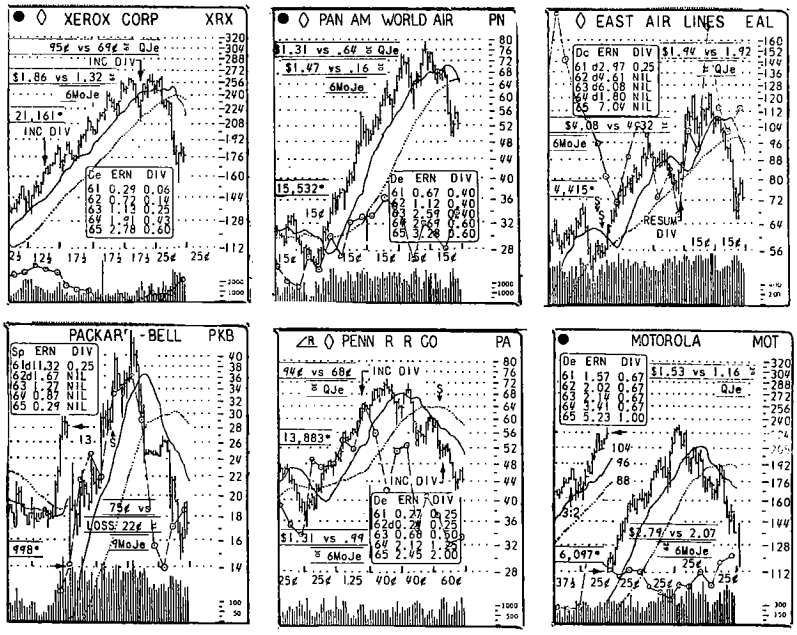
QUESTION: Why haven't you advocated silver shares or why haven't you been as insistent on subscribers' holding silvers as golds? ANSWER: If we are going into a recession or depression, which I believe we are, then consumption of silver will drop off sharply. There will be pressure on all commodity prices with the exception of gold. Of course, if the price of gold is raised the value of silver will also increase as there is an historical ratio between the price of silver and gold. However, I feel that gold shares will prove to be the safer investment. I still want to underscore the fact that I never advocated holding gold shares as "a great speculation in a bear market." I advocated holding 10% to 15% of assets in golds as a hedge in case the price of gold is raised. Most of the golds would show huge leveraged-gains if the price of gold is raised. For this reason, a big (percentage) position in gold shares is not necessary. If you hold a 10% position in gold and the value of that position drops 50%, you will only show an overall paper loss of 5%. But if that same 10% gold position increases 500% in value, you will show an overall paper profit of 60%.

QUESTION: What do you think of holding real estate during a bear market? ANSWER: To my mind, real estate (and land) is one of the most inflated and vulnerable "commodities" on the market today. I believe real estate is in for a major deflation in value over the period ahead. In many cases, land is being held as a pure speculation, and here in San Diego I have seen residential acreage valued at $20,000 to $30,000 per acre which I do not think will bring $3,000 per acre when this bear market hits bottom. In many cases, buildings and houses are now terribly over-valued, and they are financed very poorly. In any sort of severe economic set-back, these houses could drop far below first mortgage valuation. In that case, people might find it cheaper to "dump" their homes, lose their small equity, and rent at far lower prices. This could result in a flood of distress housing on the market, and such a flood could depress prices drastically. Real estate, in the past, has

proved to be almost impossible to unload under adverse conditions, in other words, unlike stocks, houses can constitute a very illiquid commodity. Ultimately, U.S. real estate will get down to real value, and many fortunes will be made buying real estate at distress prices. Following 1929, a goodly number of shrewd investors made millions buying boom-time housing at 10¢ on the dollar. I feel that this generation is due to see a repeat of the boom-bust real estate cycle.

QUESTION: Would you be a buyer of bonds here? ANSWER: I discussed this question briefly in Letter 332. The question really amounts to, "Have bond yields topped out?" The answer is that although bond yields are generally at or near 40-year highs, nobody really knows whether they have topped out. In Letter 332 I suggested placing 12% to 25% of cash earmarked for bonds in the current bond market. In other words, averaging in at currently very high yields. Many Government bonds (long-term) were then, and still are, in the 6% yield zone. At 6% money doubles every 12 years. Since many bonds are selling at 10% or more below maturity price, purchases here will provide a high rate of return plus a capital gain at the time of maturity when the bond is redeemed at par or $1,000. We are certainly in the area of once-in-a-lifetime opportunities in the bond market. But do not forget this. Bonds could definitely go lower, they could go much lower. There could be a general (perhaps final) "wash-out" in the bond market as the Government comes in for massive financing, taking on all comers for money. Banks, now in severe straits, could dump more of their bond portfolios on the open market in an effort to raise much-needed funds. The war in Vietnam could be stepped up and Thailand could become another war-spot, thus necessitating further need for Government financing. No one knows what lies ahead in this bear market, and therefore no one knows how low bonds will go. Current bargains in bonds could become even greater bargains, and this is the reason I suggest "averaging down" in the bond market. Personally, for my own account, I have not purchased any bonds of any type. I have stayed with the 91-day Treasury bills currently yielding around 5½%.

QUESTION: With a war going on and threatening to get bigger, how can stocks really be expected to go into a major bear market? Isn't business just too good? ANSWER: Business is good now, but it's going to have problems. For instance, right now the corporate profit rate is slowing down even while capital spending is strong. With interest rates high and a tax increase coming after election, many corporations are now preparing to hoard cash by cutting dividends. During the first half of 1965, the cash-dividend rate on the N.Y.S.E. was up 16% over 1964. That rate dropped to 9.6% in the first half of 1966. Last month, 17 Big Board firms skipped dividends while 10 reduced them. This is a foretaste of things to come. Another problem is overcapacity. For instance, in the chemical industry almost everybody is now in fibers. U.S. nylon production (with 23 current producers) is slated to go up 20% this year. But demand is only growing by 8% per year. Foreign producers are now increasing their nylon exports at triple the 1964 rate. As a result, nylon prices are buckling. This same phenomenon is occurring in autos, steel, copper, etc. During a bear market demand can be expected to decrease. This will occur in the face of rapidly increasing production, leading to a collapse in prices. Thus, factors can change rapidly, and bright spots can turn dull amost overnight. The stock market is now discounting next year's corporate outlook. The market is saying that it does not like what it sees.



STOCKS: I have stated before that I believe we are in the early part of the second phase of the bear market. The first phase ended a few months ago. During the first phase of a bear market, stocks sell minus the "froth" of the preceding bull market's final speculative phase. With this in mind, it is worth looking at a few of last year's speculative favorites. It should be remembered that all speculative run-ups in individual stocks must start with informed accumulation. Once the stock starts moving up steadily it is bound to draw attention to itself. The greater and longer the rise, the bigger the "following" and the greater the volume generated. But sooner or later such profit-making action must bring in the public, the "Johnnie-come-lately" and the in-and-out scalper. At or near the top, the high-flying issue moves out of the hands of the informed accumulators and into the weak hands of the amateur traders. When the market tops, the weak hands develop weak hearts. Then it is a case of "see how they run." The stocks shown on these weekly charts were all speculative favorites last year. Each started up after intelligent accumulation. Each topped out after a period of uninformed or "weak" buying. The result is clear to see--frightful losses to the later-comers. (Charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas).

LATE NOTES: After dropping 13 points yesterday, the market opened lower today (Thursday, Sept. 29). Interestingly, yesterday's odd-lot ratio was 71, which means that odd-lotters bought 10 shares for every 7 sold. This is an increase in buying over the previous day and the heaviest odd-lot buying of the week. In other words, the odd-lot public still believes that lower prices provide "bargains." Such sentiment is bearish for the market, and it suggests that this market will drop until the "little fellow" finally panics on lower prices. If the Average jointly penetrates the August lows of 767.03 and 190.48, I would expect some very "rocky" days ahead with possible panic conditions.